

Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [REDACTED] TL-N-4405-99-LO
[REDACTED]

date: NOV - 3 1999

to: Chief, Examination Division, [REDACTED]
Attn: [REDACTED]

from: District Counsel, [REDACTED]

subject: Request for Advisory Opinion
Taxpayer: [REDACTED] & Subsidiaries
Issue: Refurbishment of [REDACTED] Airplane

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[REDACTED]

(b)(5)(AWP)

[REDACTED]

[REDACTED]
District Counsel

By: [REDACTED]

[REDACTED]
Attorney

Office of Chief Counsel
Internal Revenue Service
memorandum

CC: [REDACTED] TL-N-4405-99-LO
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DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Collection, Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on the Examination Division and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

This memorandum responds to your request for an advisory opinion concerning the above-referenced case.

ISSUE

Whether the refurbishment expenses for the DC-10 airframe and three related engines are a reduction to taxable income as (a) ordinary and necessary business expenses or (b) capital expenses for which a deduction is allowed for depreciation when the aircraft is returned to service.

CONCLUSION

The costs incurred by [REDACTED] for major inspection and rehabilitation of the DC-10 may not be deducted as ordinary and necessary business expenses under I.R.C. § 162. These costs must be treated as capital expenditures under I.R.C. § 263 and depreciated in accordance with I.R.C. §§ 167 and 168 when placed in service in a subsequent period.

DISCUSSION

Taxpayer is the owner of a DC-10 airplane, which it leases to commercial airlines. During the taxable year in question, taxpayer repossessed its DC-10 from an airline, due to that airline's failure to keep up with its lease payments, and to complete the required scheduled maintenance. The repossessed airplane was in need of repair, and was inoperable. Pursuant to a settlement agreement with the airline, the taxpayer had the necessary repairs completed, and had the lessee airline pay \$ [REDACTED] for the airframe overhaul and \$ [REDACTED] for the engine refurbishment. Other than costs related to legal matters, security, and storage of the DC-10, the taxpayer incurred \$ [REDACTED] of expenditures. Of that amount, taxpayer capitalized \$ [REDACTED] the amount required to purchase and install new seats for the airplane, and incorrectly deducted \$ [REDACTED] the remaining refurbishment expenditures.

Section 263 of the Internal Revenue Code provides the rule regarding capitalizing expenditures. This section states that no deduction shall be allowed for permanent improvements or betterments made to increase the value of any property. The regulations under section 263 also provide that the amounts used to adapt property to a new or different use are not currently deductible. Treas. Reg. § 1.263(a)-1(b).

Section 162 allows for "deductions for ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." The Treasury Regulations further explain how this concept applies to repairs.

The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense, provided the cost of acquisition or production or the gain or loss basis of the taxpayer's plant, equipment, or other property, as the case may be, is not increased by the amount of such expenditures. *Repairs in the nature of replacements,*

to the extent that they arrest deterioration and appreciably prolong the life to the property, shall either be capitalized and depreciated in accordance with section 167 or charged against the depreciation reserve if such an account is kept.

Treas. Reg. § 1.162-4 (emphasis added).

Capitalizing expenditures is the rule, and deducting under section 162 is the exception. INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992). In fact, the taxpayer has the burden of proving the right to a deduction, and deductions are only permitted when there is a clear provision for them in the Code.¹ Id.

The Courts considered the rules set forth under sections 162 and 263 in numerous cases. In its attempt to clarify, what is essentially a case-by-case, fact-specific determination, the Court listed factors used to determine the applicability of sections 162 and 263. Currently, the most prominent case on the subject is INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992). This case explained that although the presence of incidental future benefits does not necessarily mandate capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred, is important in deciding whether the cost should be capitalized. Id.

In this instance the repairs to the airplane included the following. The airplane's [REDACTED] engines were overhauled. The airframe underwent D-check inspections. According to the revenue agent, these inspections include extensive disassembly, repair and/or replacement of components of the airframe. The items removed for a D-check include cabin side and ceiling panels, baggage and stowage bins, alleys, lavatories, floor boards, flight control surfaces (flaps ailerons, etc.), landing gear and engines. In addition to the engine refurbishment and the airframe inspections, the taxpayer also remodeled the interior of the airplane.

The work done to the airplane in this instance was clearly intended to benefit the taxpayer beyond the taxable year. The airplane's engines were refurbished to a point where the arithmetical average of the remaining cycles for such engines was not less than [REDACTED] hours. Although the taxpayer indicated that they utilized used parts when possible, the engine was

¹ This burden of proof has not been tested under I.R.C. § 7491.

refurbished to last longer than one year.² See, e.g., Hudlow v. Commissioner, T.C. Memo. 1971-218 (holding that an amount incurred to repair forklifts was a capital expenditure, where the forklifts were overhauled, their lives were prolonged and their values increased.) In fact, the taxpayer re-leased the airplane after the refurbishment, in what is assumably a multi-year lease. Comparable lease terms would likely not have been attainable without the refurbishment of the airplane.

Taxpayer's refurbishment is similar to the refurbishment considered in TAM 96-18-004 (Jan. 23, 1996). The Service there reasoned that the costs for major inspections of aircraft engines should be categorized as capital expenditures. The reasoning was that the costs resulted in substantial improvements to the condition of the engine, adding value to the engine, and adding time to the engine's useful life. "The expenditures generated significant future benefits to the taxpayer, not the least of which is the fact that without them, the FAA would not permit taxpayer to continue to operate its aircraft." Similarly, the refurbishment here not only resulted in significant improvement to the overall condition of the engines, but also afforded similar benefits to the overall condition of the airframe. The expenditures added value to the aircraft, as well as added time to the aircraft's useful life. Furthermore, without the taxpayer's refurbishment, the FAA would not permit an airline to operate this airplane. Thus, it would be difficult, if not impossible for the taxpayer to re-lease the airplane for the same amount of income, had the aircraft not been air-worthy. The taxpayer, therefore, benefits from the refurbishment over the term of the lease.³

TAM 96-18-004 (Jan. 23, 1996) also considered the general plan of rehabilitation doctrine. Under that doctrine, expenditures made pursuant to a general plan of rehabilitation or improvement must be capitalized, even if said improvement alone

² The Work Scope, labeled "Exhibit A", indicates that all "hard time components having less than [REDACTED] months of serviceable life, [REDACTED] cycles, or [REDACTED] working hours" were replaced. It takes approximately four years to register 6,000 to 7,000 flight hours, according to TAM 96-18-004 (Jan. 23, 1996). Furthermore, according to Ernst & Young's Airline Industry Report, dated March 10, 1993, on average, D-checks are performed on airplanes every 12,000 hours of flight time, or approximately every 5 years.

³ It would, therefore, be important to see a copy of the new lease.

would justify a current deduction. The TAM found that repeated engine inspections over the years increased the service life of the airplane more than 18 years. It therefore held that the taxpayer was to consider the individual repairs as a consolidated refurbishment plan which should be capitalized.

The general plan of rehabilitation doctrine was also discussed in Rev. Rul. 88-57, 1988-2 CB 36. In that ruling, the Service ruled that the taxpayer entered into a general plan of rehabilitation, where the taxpayer established a program for cyclical rehabilitations of its railroad freight cars. Under that program, taxpayer refurbished his freight cars every 8 to 10 years. Each refurbishment included a complete disassembly, inspection, and recondition or replacement of all of the freight car's parts. Without such reconditioning, the useful life of the freight cars would be roughly 12 to 14 years. However, with repeated rehabilitations, the cars could last as long as 30 years. See, e.g., Griffin Industries, Inc. v. United States, 389 F.2d 802 (Ct. Cl. 1968); Norwest Corp. v. Commissioner, 108 T.C. 265 (1997); United States v. Wehrli, 400 F.2d 686 (10th Cir. 1968).

Similarly, [REDACTED] extended the life of its airplane through a series of inspections, disassembly, and reconditioning or replacement of worn out parts. The general plan of rehabilitation in this case was more extensive than the plan considered in TAM 96-18-004 (Jan. 23, 1996). In this case, the taxpayer not only refurbished the engines, it also refurbished the entire plane, including refitting it with new seats, repainting parts of the aircraft, reinstalling it with overhauled landing gear, and installing new carpet. In fact, the refurbishment prepared the plane to be the subject of a new lease agreement. Thus, according to the general plan of rehabilitation doctrine, as well as Treas. Reg. § 1.263(a)-1(b), which refers to the adaption of property to a new use, the refurbishment expenditures are not currently deductible. [REDACTED] adapted the aircraft for the new lease, thus, extended its useful life as leasable property. By refurbishing the aircraft so that it could be re-leased, [REDACTED] increased the plane's value, prolonged its life, and arrested the deterioration of the aircraft. Furthermore, these improvements will benefit [REDACTED] for over a year. Thus, the improvements satisfy the criteria for capitalization under Treas. Reg. § 1.263(a)-1(b), (arresting deterioration and appreciably prolonging the life of the property), and the important factor pursuant to INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992), (realizing benefits beyond one year). We therefore agree that the repair expenditures should be capitalized, and not deducted.

Although the taxpayer claims that it should be permitted to currently deduct the expenditures for the refurbishment of the aircraft, it has not asserted any authority under which it can take that position. [REDACTED] could claim that the inspection and repairs did not materially enhance "the value, use, life expectancy, strength, and capacity" of the airplane as compared with the condition of the property prior to the event necessitating the repairs. Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333, 338 (1962), nonacq., 164-2 C.B. 8 (holding that the taxpayer could currently deduct inspection costs); See TAM 96-18-004 (Jan. 23, 1996). This case law, however, is not controlling in this case because the aircraft was not damaged by one act, and the repairs were necessitated by wear and tear over a period of time. Id. Therefore, [REDACTED] cannot successfully assert Plainfield-Union as authority to currently deduct its expenses relating to the refurbishment of the aircraft.

Lastly, [REDACTED] included the settlement amount received from [REDACTED] as income on its tax return. Another possible position that [REDACTED] could take in response to the requirement that it capitalize its repair costs, is to argue that the settlement amount is not includable in gross income. This argument could be made pursuant to I.R.C. § 1033, by asserting that the damage to the airplane was an involuntary conversion. However, the damage to the airplane was not the result of "destruction", thus, section 1033 should not apply, and the settlement amount is includable in income as it represents lease payments owed by [REDACTED]. If, however, [REDACTED] was successful in asserting that section 1033 does apply, then it would not be entitled to its current deductions for the refurbishment expenses, and would only get depreciation deductions for said expenses in accordance with I.R.C. §§ 167 and 168, based upon the aircraft's basis as determined by I.R.C. § 1033(b).

Please note, we consider the opinions expressed in this memorandum to be significant large case advice. We therefore request that you refrain from acting on this memorandum for ten (10) working days to allow the Assistant Chief Counsel (Field Service) an opportunity to comment. If you have any questions regarding the above, please contact [REDACTED] at [REDACTED] or [REDACTED] at [REDACTED].

[REDACTED]
District Counsel

By: [REDACTED]

Attorney

cc: Deborah Butler
Assistant Chief Counsel, (Field Service)

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Assistant Regional Counsel (LC), [REDACTED]